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Internal Revenue - Depreciation - Rights of Life Tenants to Depreciate Improvements

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A second rule enunciated is that the validity of contracts is governed by the law the parties intended to govern.[22] Under the third rule, the law of the state contemplated as the place of performance governs.[23] In the instant case it is arguable that the parties intended to be governed by the law of the state where the insured contracted liability. Application of either of the latter two rules might require a result different from that reached by this court. However, the opinion rendered appears sound on principle. The rule most generally accepted governs contracts according to the law of the place where they are entered. This rule has the additional merits of simplicity and certainty in most cases.[24]

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INTERNAL REVENUE — DEPRECIATION — RIGHTS OF LIFE TENANTS TO DEPRECIATE IMPROVEMENTS. — Petitioner and her husband entered into a trust agreement whereby certain real property was conveyed as a gift in trust to a daughter, subject to a life estate in themselves and the survivor. Subsequently, after the death of her husband and at the age of 73, the petitioner razed an unproductive building on the property and built a new office building so that she might profit from her life estate. The useful life of the building was 50 years and her life expectancy was then 7.26 years. Petitioner claimed a deduction for depreciation based on her life expectancy in her income tax returns. The Court of Appeals held that depreciation was to be computed over the life of the property and not over the life expectancy of the tenant for life. *Penn v. Commissioner of Internal Revenue*, 199 F.2d 210 (8th Cir. 1952).

Depreciation, a matter of legislative grace,[1] is allowed as a deduction from gross income in determining the net taxable income.[2] The allowance applies only to property used in the trade or business of the taxpayer provided he has supplied the capital which has gone into the property.[3] A de-

22. This view has been rejected by text writers. 2 Beale, Conflict of Laws 1079 (1935); Goodrich, Conflict of Laws 325 (3rd ed. 1949); and by the courts, New York Life Ins. Co. v. Cravens 178 U.S. 389 (1900); Ragsdale v. Brotherhood of Railroad Trainmen, 229 Mo. App. 545, 80 S.W.2d 272 (1934).

23. See 2 Beale, Conflict of Laws 1086 (1935); Goodrich, Conflict of Laws 324 (3rd ed., 1949).

24. See 2 Beale, Conflict of Laws 1090 (1935); see Note 16 A.L.R.2d 881, 890 (1951).

1. *See* Sunray Oil Co. v. Commissioner, 147 F.2d 962, 965 (10th Cir. 1945), *cert. denied*, 325 U.S. 861 (1945); Detroit Edison Co. v. Commissioner, 131 F.2d 619, 622 (6th Cir. 1942), *aff'd*, 319 U.S. 98 (1943) "Like all other deductions, the allowance is a matter of legislative grace."

2. Int. Rev. Code §23 (*l*): "In computing net income there shall be allowed as deductions:

(*l*) Depreciation.—A reasonable allowance for the exhaustion, wear and tear (including a reasonable allowance for obsolescence)—

(1) of property used in the trade or business, or

(2) of property held for the production of income."

3. City Nat. Bank Bldg. Co. v. Helvering, 98 F.2d 216, 219 (D.C. App. 1938), "The test is, can the claimant, whatever his relationship to the property — as owner, lessee, lessor, etc., — show a depreciating capital investment? The purpose of the depreciation allowance is to permit a person whose money is invested to recover through annual deduction an amount equal to the original outlay." See Weiss v. Weiner, 279 U.S. 333 (1929) (99 year lessee not permited to depreciate lessor's property); *see* Century Electric Co., 15 T.C. 581, 585 (1950); Gladling Dry Goods Co., 2 B.T.A. 336, 338 (1925) (the important question is who made the investment to be recovered over the period of depreciation).

duction is allowable to a taxpayer if he is an owner [4] or a lessee [5] but in either case it is fundamental that there must be a present loss of invested capital.[6] Courts allow a purchaser of a life tenancy to depreciate the purchase price over his life expectancy.[7] Lessees may depreciate improvements made by them over the life of the lease or over the life of the improvement, whichever is shorter.[8] While it is true that a lease is not a freehold interest in land,[9] yet the improvement is lost to the lessee when the lease expires.[10]

In the instant case, the petitioner relied upon the decision of the Board of Tax Appeals in *Caroline T. Kissell.*[11] in which it was held that a building erected by a life tenant could be depreciated over the life tenant's life expectancy since it could be considered a purchase of a life estate because paid for out of the life tenant's own funds. The court rejected the idea that the *Kissell* case was controlling because the Revenue Act of 1921,[12] which was applicable in that case, provided for a *reasonable* allowance for the wear and tear of property used in trade or business. As construed by the court, the statute applicable in the present case provides that where property is held by a life tenant with remainder to another person, the deduction is to be computed over the useful life of the property.[13]

Petitioner further contended that the statute was intended to apply solely to improvements on the property at the time of the creation of the life tenancy and not to cases where the improvements are placed on the property at the expense of the life tenant after the estate has vested. The Court of Appeals answered this contention by saying that "no such restriction can be found in the statute, in its legislative history, or in the Treasury Regulations applicable." [14] It seems doubtful that this is so; in fact, a survey of the history of the statute, which ought to be a persuasive if not decisive factor in

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4. See note 3 *supra*.

5. 353 Lexington Avenue Corp., 27 B.T.A. 762 (1933) (lessee who built on leased premises allowed to depreciate building over life of lease); Duffy v. Central Ry., 268 U.S. 55 (1925) (lessee could depreciate improvements financed by him over life of lease). *But cf.* Standard Tube Co., T.C. 950 (1946) (since lease is for indefinite period, lessee must depreciate permanent improvements made by him over useful life).

6. See note 3 *supra*.

7. Floyd M. Schoemaker, 16 B.T.A. 1145 (1929) (purchaser of a life estate allowed to deduct annuity payment as depreciation); Elmer J. Keitel, 15 B.T.A. 903 (1929) (court held that the purchaser of life interest held a capital investment which should be depreciated over the life expectancy of the tenant per autre vie).

8. Duffy v. Central Ry., 268 U.S. 55 (1925) (lessee allowed to depreciate improvements financed by him over life of lease on first lease and over the life of the improvement on second lease).

9. *See* Insurance Co., v. Haven, 95 U.S. 242, 250 (1877) (leases for years are chattel interests, not freeholds); Burdick, Real Property 24 (1914).

10. Burdick, Real Property 25 (1914); Tiffany, Real Property 410 (1940).

11. 15 B.T.A. 705 (1929); *cf.* Grant v. Rose, 32 F.2d 812 (N.D. Ga. 1929) aff'd, 39 F.2d 338 (5th Cir. 1930) *cert. denied*, 238 U.S. 867 (1931) (life tenant allowed to depreciate improvements which he purchased over his life tenancy).

12. 42 Stat. 240 (1923): "Sec. 214 (a). That in computing net income there shall be allowed as deductions:

(8) A reasonable allowance for the exhaustion, wear and tear of property used in the trade or business, including a reasonable allowance for obsolescence."

13. Int. Rev. Code §23 (*l*) provides that "in the case of property held by one person for life with remainder to another person, the deduction shall be computed as if the life tenant were the absolute owner of the property and shall be allowed to the life tenant." The court said in the instant case that the rule of depreciation applicable to absolute owners was applicable to the life tenant, *i.e.*, that depreciation was to be computed on the basis of the useful life of the property.

14. Penn. v. Commissioner, 199 F.2d 210, 212 (8th Cir. 1952).

construing it,[15] indicates that precisely the opposite inference may be drawn.

In carrying out the mandate of the Revenue Act of 1921, that a "reasonable" amount was to be allowed as a deduction for depreciation, the courts had developed the following rule: The life expectancy of the tenant for life was first divided by the useful life of the property. The value of the improvement was then multiplied by the result of the foregoing computation, the figure arrived at by this means being the present value of the life tenant's estate. This computation may be expressed as follows:

$$\frac{\text{life expectancy of life tenant}}{\text{useful life of property}} \times \text{value of improvement} = \text{present value of tenant's estate.}$$

Once the present value of the tenant's estate for life is ascertained, it was then divided by the life expectancy of the tenant for life, the result being the annual deduction for depreciation allowed the life tenant.[16] But the courts had held that the rule of apportionment under the Revenue Act of 1921 applied only to improved property coming into the hands of a life tenant.[17] Improvements made at the expense of the life tenant were depreciated on the basis of his life expectancy.[18] Congress incorporated the rule of apportionment as stated by the courts into the Revenue Act of 1926,[19] which stated that in the case of *improved* real estate held by a life tenant, the deduction was to be equitably apportioned between the life tenant and the remainderman. Thereafter, in an effort to clarify the statute and reduce hardship and uncertainty to life tenants,[20] Congress provided in the Revenue Act of 1928[21] that where property was held by a life tenant, the deduction was to be computed over the useful life of the improvement. It should be noted that the amount of the deduction computed by the rule of apportionment under the earlier Revenue Acts and under the Revenue Act of 1928 are necessarily the same where the improvements are not erected by the life tenant since the

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15. Baldwin v. Bowles, 57 F. Supp. 637 (W.D.S.C. 1944); *see* Helvering v. Morgan's, Inc., 293 U.S. 121, 126 (1934) "But the true meaning of a single section of a statute in a setting as complex as that of the revenue acts, however precise its language, cannot be ascertained if it be considered apart from related sections, or if the mind be isolated from the history of income tax legislation . . ."; Helvering v. N.Y. Trust Co., 292 U.S. 455, 464 (1934); Willcuts v. Bunn, 282 U.S. 216, 234 (1931)

16. H. C. Brown, 25 B.T.A. 631 (1932) (depreciation equitably apportioned between tenants per autre vie and remainderman); Rose v. Grant, 39 F.2d 338 (5th Cir. 1930), *cert. dismissed,* 283 U.S. 867 (1931) (depreciation of office building was fairly apportioned between the life tenant and the remainderman); *cf.* 9 B.U.L. Rev. 288 (1929).

17. Grant v. Rose 32 F.2d 812 (N.D. Ga. 1929), *aff'd* 39 F.2d 338 (5th Cir. 1930) *cert. denied,* 283 U.S. 867 (1931).

18. Caroline T. Kissel, 15 B.T.A. 705 (1929) (life tenant allowed to depreciate improvements made at his expense); Grant v. Rose, 32 F.2d 812 (N.D. Ga. 1929), *aff'd,* 39 F.2d 338 (5th Cir. 1930), *cert. denied,* 283 U.S. 867 (1931).

19. 44 Stat. 26 (1926). "Sec. 214 (a). In computing net income there shall be allowed as deductions:

(8) a reasonable allowance for the exhaustion, wear and tear of property used in the trade or business. . . . In the case of *improved* real estate held by one person for life with remainder to another person, the deduction provided for under this paragraph shall be equitably apportioned between the life tenant and the remainderman. . . ." (emphasis supplied).

20. I.R.B. 16, 1939-1 Cum. Bull. 422.

21. 45 Stat. 800 (1928). "Depreciation. . . . In the case of property held by one person for life with remainder to another person, the deduction shall be computed as if the life tenant were the absolute owner of the property and shall be allowed to the life tenant." It should be noted that this provision is the provision presently appearing in the Internal Revenue Code. Int. Rev. Code §23 (*l*).

basis for computing depreciation under both rules is the useful life of the property.[22] A tenable argument apparently not presented by the petitioner is that Congress in the Revenue Act of 1928, did not intend to change the law as to depreciation in the case of life tenants but only to introduce a simple and concise rule for computing depreciation, thereby eliminating the confusion produced by the rule of apportionment. Therefore, since improvements made by the life tenant were excepted under the Revenue Act of 1921,[23] they should also be excepted under the Revenue Act of 1928 and thus under the present provision, which is a carry-over of the 1928 legislation.

Clearly, the petitioner in this case was the victim of an unfortunate decision. The fact that the cost was recovered within the first five years of the building's use rebuts any presumption that a gift to the daughter was intended.[24] But on the death of the petitioner her estate will be unable to recover the undepreciated cost of the building from the remainderman because it is well settled that a life tenant cannot burden the estate of the remainderman with the cost of improvements even if they enhance the value of the property.[25] The result reached by the court may therefore be criticized on the ground that it discourages legitimate business enterprises and forces life tenants to allow valuable business property to fall into ruin because of natural wear and tear, obsolescence, and changing conditions. Appropriate legislation to allow life tenants to depreciate improvements financed by them over their life expectancies would appear to be distinctly desirable.

JOHN G. MUTSCHLER

LIMITATION OF ACTIONS — IGNORANCE OF EXISTENCE OF THE CAUSE OF ACTION — STATUTE BARRED UNDISCOVERED CAUSE OF ACTION FOR MALPRACTICE, — The defendant performed an operation upon the plaintiff on December 8, 1942, and negligently failed to remove a surgical sponge from

22. By applying the rule of apportionment used under the 1921 act to a hypothetical case where the life expectancy of the life tenant is 10 years, the useful life of the property is 20 years, and the present value of the property is $20,000, the following result is reached:

10/20 x $20,000 = $10,000 ÷ 10 = $1000 annual depreciation.

Applying the rule of the present act to the same case, the same result is reached: $20,000 ÷ 20 = $1000 annual depreciation.

The similarity in results illustrates the fact that the present act is merely a codification of the judicially-developed rule of apportionment applied to improved property under the Revenue Act of 1921.

23. See note 19 *supra*.

24. The building was erected in 1938 at a cost of approximately $17,000. The petitioner received from $4,000 to $5,000 per year rental from 1938 to 1943. From 1943 to 1950 she received $68,604. Considering the improvement from a business standpoint, it represented a prudent investment for her own account. *Cf.* Caroline T. Kissel, 15 B.T.A. 705, 706 (1929): "Since petitioner is deriving rentals from the building, it follows that she is using the building in her business."

25. *E.g.*, Dickey v. Stevens, 208 Ark. 111, 184 S.W.2d 955 (1945) (grantor who retained life estate not allowed to charge the remainderman for improvements); Belfield v. Findlay, 389 Ill. 526, 60 N.E.2d 403 (1945) (improvements are deemed to have been made for the benefit of the life tenant); Caldwell v. Jacob, 16 Ky. L. Rep. 21, 24, 22 S.W. 436, 437 (1893), *modified on rehearing*, 24 S.W. 86 (1894) (court gave two reasons why improvements cannot be made a charge upon the estate of the remainderman: 1) To prevent the life tenant's consuming the remainderman's interest by making improvements the remainderman does not desire or cannot pay for; 2) Improvements are made for the benefit of the life tenant's benefit, and usually without reference to the remainderman's wishes.). *But cf. In re* Whitney, 75 Misc 610, 136 N.Y.S. 633 (1912) (life tenant allowed compensation for improvements).